Business Europe/ *By Bijan Khezri*

# *A CEO's Take on Corporate Reform*

Accounting fraud, incompetence and excessive indebtedness at some of the world's leading companies have shaken our confidence in the publicly listed company. At the heart of the crisis lies the traditional principal-agent conflict that arises when ownership is separated from control. The commonly accepted view is that, in particular, the board of directors has failed to control greedy executives who have fallen victim to their own obsessive appetite for risk-taking and self-importance.

Regulators will now focus on strengthening corporate governance. Yet any revised regulations are likely to fall short in both restoring investor confidence and reducing the likelihood of future casualties.

As a first step, we need to distinguish cause from effect. It is not the mastering of risk-management processes that forms the basis for successful corporate governance, but the directors' true understanding of the underlying business as well as the quest for sustainable competitiveness.

The origin of this corporate crisis can only be fully appreciated when analyzed in the context of the 1980s' highly leveraged buy-out market. This era laid the foundation for a system that became aggressively geared toward equity holders, even to the detriment of the proper functioning of the business itself.

The late 1980s buy-out market facilitated a wide-ranging asset reallocation that unleashed unprecedented value creation and gave birth to the concept of shareholder value. This retrenchment relied heavily on the successful combination of four factors. First, greed as a motivational force; second, aggressive capital-market financing; third, competitiveness as the performance benchmark; and fourth, an open and highly competitive market for corporate-control—that is, the hostile takeover market. This last factor was the driver of overall business competitiveness, leading to the break-up of clubby boardroom relationships and optimizing executives' pay-performance ratio.

During the 1990s, however, that formula for success has been reduced to a combination of ever-increasing greed, equity-biased capital-market financing and strategic mergers and acquisitions where growth for the sake of capital gains has become the overriding objective. This time, value creation outstripped previous boom periods and an increasing number of shareholders—both institutional and private—participated in the rally. Indeed, the success became so popular that, in many ways, it turned into heaven's ground for politicians.

Most importantly, however, the corporate-control market closed, leaving CEOs in undisputed control over their shareholders' companies. In effect, the CEO's monopoly status has become a benchmark for corporate strength and competitiveness and was heavily encouraged by institutional investors and investment banks as they backed the CEO rather than the business.

Excessive management option packages fueled greed and encouraged corporate leverage. This, in addition to M&A activity that was driven more by strategy than by operational considerations, became the system's predominant characteristics, and the strength of the share price emerged as the fundamental pillar for the survival of the system. The first signs of a weakening share price set the scene for turmoil and collapse as share-price sensitive debt became unsustainable and innovative profit-boosting schemes to support share price performance were uncovered.

> ***The current crisis was pre-programmed. The capital markets' obsession with growth encouraged CEOs to monopolize their businesses.***

During the 1990s, directors' performance was increasingly measured against how well they understood both the mechanics of M&A and capital markets and their ability to keep the "winning team" motivated to take the business to its next growth phase. Today, mistakenly, the crisis has reduced corporate governance to a debate about risk management as everyone is struggling to address the imbalances of the past. Sustainable business competitiveness, however, remains the true subject matter.

Irrespective of the strength of any risk-management processes and policies, non-executive directors will never be able to fully appreciate their corporate-governance responsibilities unless they go beyond the board table and fully understand the business they are meant to supervise. Directors have become too complacent with their obsession for process. Substance is missing.

In order to both understand the company's risks and opportunities as well as detect the CEO's weakening performance at an early stage, the board must continuously engage with the broader management team at different levels. Hence, the debate on whether the CEO and CFO should be the only executives on the board or whether executive representation should be broader is meaningless. Business intelligence accessed through senior executives around the board table is, by nature, limited at best and, therefore, cannot form the sole basis for effective corporate governance.

Proactive engagement is of especially vital importance now, as two critical developments have robbed directors of corporate governance's traditional allies. First, the fundamental role commercial banks used to play in corporate governance has been diluted. This role for "house banks" survives to some extent in Continental European markets such as France and Germany, but capital markets' aggressive disintermediation of corporate finance, in particular in credit markets, has greatly diminished their influence.

Second, as strategic M&A rather than basic operations emerged as the benchmark for success, the role of the CFO as both trustee of numbers and ultimate financial controller has increasingly converged towards the role of the CEO as strategic thinker and manager. It is, in particular, this trend that has substantially weakened corporate governance as the board continues to rely on the CFO in its mandate to supervise and control the business.

The current crisis had been pre-programmed. It is the equity capital market's unsustainable short-termism, lack of patience and obsession with growth for the sake of capital gains that not only stamped its culture on the public stock company but also encouraged the CEO to monopolize the business. The now infamous CEOs and CFOs are a caricature of a system that has been dominated by institutional investors and investment banks: a system that has become obsessed with capital markets—not as a medium but as an end in itself—at the expense of building sustainable business competitiveness.

Total business focus—rather than an obsession with capital markets—will have to guide the way forward. Business leaders have preached that by focusing on customers and employees first, shareholder-value will follow. Few have lived up to it.

The most important reforms for restoring "investor confidence" will not come from without, but from within the corporate structure itself. The current "crisis" represents a real opportunity for the board of directors, including the CEO, to assume leadership in rebuilding confidence and trust in the public company—for the long-term benefit of all stakeholders. As shareholders turn their backs on equity ownership, corporate boards can bring them back by responding in kind. More focus on the business of business, and less on daily stock-price fluctuations, will create the value that will bring shareholders back for the long run.

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